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C O N F I D E N T I A L SECTION 01 OF 02 SANAA 001875

SIPDIS

PLEASE PASS TO MICHAEL GRIFFERTY, US TREASURY REGIONAL
OFFICE ABU DHABI.

E.O. 12958: DECL: 07/11/2015
TAGS: ECON EFIN EINV YM ECON COM
SUBJECT: YEMENI RIYAL SHOWS SIGNS OF INSTABILITY

Classified By: CDA Nabeel Khoury for reasons 1.5 b and d.

¶1. (U) Summary. The Yemeni Riyal has fluctuated dramatically in recent months, and the Central Bank of Yemen (CBY) intervened on at least two occasions to combat devaluation. Despite these efforts, for the first time in three years a black market has emerged for buying foreign currency, and the falling Riyal has led to rising commodity prices and increasing uncertainty for the average Yemeni. IMF and World Bank analyses indicate that the Riyal is overvalued, and recommend gradual depreciation to encourage Yemen's non-oil production and export capacity. Nevertheless, the ROYG appears committed to a strong currency and the import economy it supports. The CBY's interventionist policy may buy short-term stability during upcoming economic reforms, but could easily spin out of control. End summary.

Cracks Appear in Yemen's Monetary Policy

¶2. (U) Spring came to Yemen with an air of instability. Recent conflict in Sa'ada and declining economic indicators (septel), undermined confidence in the value of Yemeni currency. At the beginning of April, the exchange rate stood below 190 YR to the US Dollar, but by late June had fallen to 197 and appeared headed for a rate of 200 YR to the Dollar. The press reported that the devaluation was causing hardship for low-income Yemenis due to higher prices for food and construction commodities. According to al-Ayyam newspaper, wholesalers raised their prices by 20-30 percent. (Note: Yemen's inflation, as measured by the consumer price index, was already averaging an annual rate of 12 percent, and has recently reached as high as 15 percent. End note.) Other reports indicate that distributors of such products as Coca Cola are hoarding supplies, awaiting clear indication of the direction of the Riyal.

¶3. (U) On July 1, the Riyal rebounded to 190 and the official rate appears to be holding steady for the time being (the current rate is 192.25). There are reports that a black market for currency has emerged in Sanaa, and that the USD is fetching 194 YR or higher on the street. (Note: The absence of such a black market until now indicated that the official exchange rate represented the true market value of the Riyal. This is no longer the case. End note.) The Riyal slipped a total of 0.7 percent against the USD in 2004. In contrast, before the Riyal rebounded this month, it had fallen 6.6 percent. Devaluation on this scale is considered a severe threat by the Ministry of Finance (MOF). According to Dr. Mohamed al-Mansoub, Assistant Deputy MOF, the MOF instructs the CBY to restrict the Riyal's depreciation against the USD to a maximum of five percent per year.

Devaluation: Good or Bad for Economy?

¶4. (U) Current devaluation appears severe to many Yemenis, but may actually be necessary for the health of Yemen's economy. A strong Riyal supports imports and discourages the development of new export sectors. Strategic devaluation could assist infant industries and prevent a sudden and painful correction in the value of the Yemen's currency in relation to the domestic economy. The IMF reports that when measured against inflation rate differentials of Yemen's major trading partners, the real exchange rate of the Riyal actually appreciated by 3.5 percent in 2004, meaning the Riyal is significantly over-valued. The World Bank contends in its Spring 2005 Yemen Update that a managed devaluation is necessary for developing the Yemeni export market and diversifying the economy. The IMF adds that pursuing such a policy now will help avoid sudden and drastic devaluations in the future, brought on by declining oil and foreign currency reserves.

¶5. (C) Despite this advice, the ROYG appears intent on maintaining the strength of its currency against the USD. According to Abdulaziz Tarmoom, Professor of Finance at Sanaa University, the ROYG allocated USD 100 million from its foreign reserves in two July installments as part of an effort to curb rapid devaluation. In its March report on Article IV consultations with the CBY, the IMF wrote that the

CBY "strongly contested any suggestion that they were pursuing a managed float." According to the CBY, the ROYG's policy was to intervene only to "dampen exchange rate volatility." An intervention on the scale described by Tarmoom indicates that the CBY is pursuing a more activist approach to monetary policy than indicated to the IMF. On July 9, a CBY spokesperson was quoted in the government daily al-Thawra, saying: "The Bank will...intervene in the currency market whenever necessary." In reality, the CBY is responding directly to political pressures from the ROYG, rather than pursuing a course of independent monetary policy for Yemen's long-term economic health.

Crude Tools to Support Riyal

¶6. (C) In another effort to control devaluation, on June 14, the ROYG instituted a new requirement that banks keep thirty percent of foreign reserves at the CBY (up from 20 percent). The apparent goal of this move, which met with the outrage of commercial bankers and the businesses, was to tie up foreign currency liquidity in the market, making it more expensive to borrow in dollars and reducing flight from the Riyal. The business community, on the other hand, contended that such a move would slow economic activity and make it more difficult for banks to meet their obligations to the market and investments. The CBY already follows a strong Riyal policy. It offers treasury bills at high rates to soak up liquidity and create demand for the Riyal, and offers negligible interest rates for foreign currency and high rates for Riyal accounts to encourage savings in Yemeni currency.

Decline of Riyal Could Contribute to Unrest

¶7. (C) Comment: During a recent visit to Yemen, US Treasury Department Regional Representative Michael Grifferty reported that a shock to the currency, "Could lead to a sudden adjustment to lower purchasing power and higher real external debt service, likely with social implications." The more the CBY attempts to stabilize the currency, the more vulnerable it appears to such a shock, which would likely accompany any deterioration in Yemen's security situation or a fall in oil prices. Until now, Yemen's single greatest economic strength has been the accumulation of USD 5.5 billion of foreign currency reserves from oil sales, considered by the World Bank to equal about 17 months of imports. The ROYG's reserves allow it to ride out fiscal crises, but they may be quickly exhausted if used continuously to support an overvalued currency. The more the ROYG intervenes, the more it undermines confidence in its currency, creating the need for more intervention.

¶8. (C) Comment continued: Yemen is nearing implementation of painful economic reform policies, including the introduction of a sales tax already adopted by Parliament, civil service reform, and the lifting of diesel subsidies (septel). These measures already controversial on their own, would be exacerbated by the simultaneous devaluation of the currency and may lead to significant social unrest. The ROYG is likely unwilling to entertain a much-needed gradual devaluation at this time. As a result, the CBY is resorting to increasingly blunt instruments to support the Riyal, and may be running out of policy options. Ironically, the lack of investment in Yemen may have prevented a more extensive monetary crisis, as there are few foreign investors looking to sell Riyals. Nevertheless, the CBY's current monetary policies are short sighted and could lead to a real currency crisis as they undermine confidence in the Riyal and tap into valuable reserves. Many of Yemen's business elite make their profits from imports, and average Yemenis depend on cheap imports for basic staples such as wheat. A currency collapse would be devastating to nearly every segment of society and would likely lead to civil unrest. End comment.
Khoury